CENTRAL EUROPEAN UNIVERSITY
CENTER FOR POLICY STUDIES

OPEN SOCIETY INSTITUTE

MILIC MILOVANOVIC

Combating Endogenous Corruption in Privatized Companies

2001/2002

CPS INTERNATIONAL POLICY FELLOWSHIP PROGRAM

MILIC MILOVANOVIC

Combating Endogenous Corruption in Privatized Companies

POLICY PAPER
SECOND DRAFT

COMBATING ENDOGENOUS CORRUPTION IN PRIVATIZED COMPANIES

Milić Milovanović, International Policy Fellow, OSI Budapest,
The Future of Southeast Europe Working Group

TABLE OF CONTENTS

EXECUTIVE SUMMARY

CHALLENGES: According to all international surveys of corruption, Southeastern Europe is among the most corrupt regions in the world. As an unintended consequence of the privatization process there emerge new kinds of corruption, although all common forms are already thriving. If the region is going to be integrated into European structures, it must subdue corruption,

BACKGROUND: Competition is a strange word in the region. It is not rife either in the product or in the input markets, and competition for positions within firms is practically nonexistent. Therefore, economic actors enjoy substantial rents. Since competition cannot be introduced overnight, and consequently rents are going to exist for a substantial period of time, it can be expected that corruption will persist. In such an environment, some methods of privatization proved to be very prone to corruption. Privatization method, together with the competition level, is a crucial factor for the extent of corruption in the post privatization period.

PROBLEM: When the ownership rights are dispersed and capital markets are underdeveloped, there is a lax control of management structure. Managers can perform their own agenda. On the other hand, they are not omnipotent, since there is an effective labor union. Both sides realize that mutual help can best further their interests. Consequently, they try to corrupt each other, and endogenous corruption has been created. It was neither imposed from the outside, nor a consequence of deteriorating living standards. This practice is the principal cause of high corruption rates in the region. Not only that it transfers tremendous amounts of wealth and creates economic inefficiencies, but it also spreads the notion that common (group) interest must prevail over the benefit of the general public.

REMEDIES: Endogenous corruption cannot be eradicated easily. Customary anticorruption devices may prove to be ineffective. Therefore, a new anti-corruption strategy must be devised for this particular pattern. Its key elements are:

- Fostering competition through foreign and internal economic liberalization;
- Establishing a clear relationship between principal and agent through the privatization process;
- Developing commercial law that limits inside-dealing, conflict of interest, and protects minority shareholders;
- Exposing vested interests in a public relations initiative;
- Creating a new governance elite by investing in human capital.

I. New Patterns of Corruption

According to all international surveys of corruption, Southeastern Europe is among the most corrupt regions in the world. Daily reports of diverted western aid, money laundering, and trade in drugs, tobacco, arms and immigrants, tend to swarm the media. Privatized companies do not pay dividends to their shareholders, and restructuring of big industrial plants is practically negligent. Lenders cannot recover their borrowed money. Usually, they even do not try to receive their due compensation through the slow and corrupted judicial system, but instead try to enforce the deal by illegal means. At the same time new forms of corruption emerge, mainly in the post-privatization period. By and large, the circumstances make foreign investors reluctant to invest in the region, yet these countries desperately need additional investments, at least to relieve the exceptionally high unemployment rates.

Therefore, it is not surprising that the international community places anti-corruption policies on top of its agenda. The most recent example is the Stability Pact offered by the European Union to the region, which has dedicated a substantial effort to combating corruption. All countries interested in the association, and eventually joining the European Union, must devise anti-corruption policies. These policies have to be designed for a long-lasting period, and also tailored to the specific forms of corruption. In other words, since corruption is a complex phenomenon, it must be unbundled and each form of corruption must have an appropriate antidote.

This paper advocates a policy against the new forms of corruption developed in the post-privatization period. Anti-corruption strategy is based on the model of emerging industrial relations in post communist countries (see the research paper). The proposed course of action will suggest certain public policies in order to enhance economic efficiency, and to diminish welfare loss due to corruption, and it will turn out to be at odds with classical anti-corruption approach.

II. Corruption and Economic Rents

Since Adam Smith it is generally believed that competition lowers rents from economic activities. In the perfect competition there are no rents since each actor receives revenue equal to costs borne by maintaining the economic activity. Consequently bribes are hard to sustain where perfect competition prevails. If, let say, some producers try to include slush funds into their cost function, there certainly will be other producers eager to sell goods cheaper by not paying bribes.

In general, lower rents reduce not only supply, but also demand for corrupt payments (lower level of extortion). Motive of officeholders to seize part of rents by means of extortion is lowered since they become aware of low profits in the industry and higher risks of exposure. Namely, with diminishing profits bribers will be more willing to expose bribees – they may lose less in profits than they gain in reputation of being honest market competitors. Moreover, since diminishing rents make high kickbacks unsustainable, rent seekers (who are on the supply side of corruption) are willing to pay fewer bribes. Consequently, the level of corruption is lowered, as both supply and demand of slush funds diminish.

If, however, competition falters, firms will enjoy higher rents, and both enterprises and bureaucrats who exert control rights over them (taxes, licenses, or regulations), have higher incentives to engage in malfeasant behavior. However, in a democratic society there are some opposing forces: high rents may also imply that the public would be keener to control both the bureaucracy and potential bribers, so the level of corruption may go down. The public in some countries is ready to spend large resources for that purpose and the effects do not miss. In spite of that, there seems to be a clear empirical finding that economic rents foster corruption.

Having in mind these simple facts, one might conclude that policies of privatization and competition are vital clues to the issue of corruption in emerging market economies.

III. Privatization of uncompetitive industries and corruption

In general terms there is a lack of competition in the ex-communist world. The competition is not rife either in the product or in the input markets, and competition for positions within the firm is practically nonexistent. Therefore, economic actors enjoy substantial rents. Since competition cannot be introduced overnight, rents are going to exist for a substantial period of time.

Moreover, as a consequence of either *voucher* or *insider privatization* schemes, the new governance structures in privatized firms are not strictly controlled either by the owners, or by the state. The owners cannot exert their influence when the ownership is dispersed or concentrated among the persons dependent on the management. Even if they can – i.e. dispersed external owners can concentrate their shares in one or two investment funds - it is very hard to replace incumbent management structure owing to the general lack of competent managers. Therefore, decentralized voucher, or insider privatization scheme, can result in dominant position of managers, although they have on the average only 3-7% of shares. Consequently, they can have a substantial leverage in dealings not only within the firm, but equally in their daily conduct with government bureaucrats. They are not only in position, but also willing to use all available means, including corruption, to further their interests.

In addition, bad management can easily replace good management in privatized companies. Privatized firms always have greater value to dishonest then to credible manager, since the first can use illegal means to collect debts, or he may pay bribes to regulators in order to obtain a privileged position. Therefore, fraudulent manager will use all accessible means to secure his position, or to acquire a new promising foothold, with an obvious objective to milk the firm's funds for his personal gain.

On the other hand, emerging market economies have weak and deficient legislation concerning such issues as conflict of interest, insider self-dealing, minority shareholder protection, or regulatory policies in general. The practicable way to keep managers in check is through the state dominated banking system, or by some extra-market forces. However, both ways are notorious of their immense opportunities for corruption and more importantly – state muddling with the market process. Reformers in many countries shun at their imposition. Therefore, management power in post-socialist countries mainly rests unopposed.

As we could have expected from the decentralized models of privatization, high rents in privatized industries are the principal source of corrupt practices. Both unaccountability of the management as a consequence of weak capital markets, and underdeveloped regulatory system, bring forth all sufficient conditions for flourishing corruption.

Yet, some other methods of privatization produce quite different ownership structure, and consequently offer fewer opportunities for corruption. For example, *sale* can result in concentrated ownership in hands of one (few) strategic investor(s). If they are, at the same time respectable foreign firms, they are unlikely to be involved in corruption practices.

By and large, some methods of privatization are more prone to corruption, particularly decentralized mass privatization, while others with dominant outside investors are less corruption ripe. We may make a conclusion that the privatization method together with competition level is a crucial factor for the extent of corruption in the post privatization period.

This is a very general statement that adds little to our ability to devise effective anticorruption policies. Since corruption can take very diverse shapes, one has to unpack it. In other words, one has to have more information on its concrete form in order to work out operative anticorruption strategy. Some classical forms of corruption can be remedied with known medicines, but new forms must be investigated by focusing on the “black box” (privatized firm), in order to discern different vested interests in the post-privatization environment.

IV. Restructuring and emerging industrial relations

A new power base has been created in privatized companies. The lax control of management structure has created a powerful force that has to be respected. On the other hand, managers are not omnipotent. As we have already pointed out, they usually have just a tiny minority of shares. Practical consequence is that some effective coalition of outsiders/insiders might jeopardize their position. As skillful players, they will take precautionary steps, which include further dilution of shares, special bonuses for big shareholders, pressure on restive laborers/shareholders, including a threat to their jobs and positions within the firm. In lawless countries they may even threat personal security of designated potential annoyers.

The labor force may try to improve its position in the post-privatization process by creating an influential workers' syndicate. The incentives for that are high, since the privatized firms are likely to be restructured, which in practice means a loss of jobs for all virtually employed. Outside expertise and outside ownership are usually indifferent to the faith of the existing labor force. Therefore, strong resistance of some, or most employees, should be expected. For them benefits from restructuring may seem quite misty and remote, losses being obvious and immediate.

On the other hand, obstacles for creation of an effective labor union are also great. The management may thwart labor efforts, fearing that strong union might endanger their position. The endeavor can be also ruined by personal ambitions of would-be-leaders. Their personal antagonism may steer the creation of several competing labor unions in the firm. Proficient managers can channel labor demands by giving selective offers and counteroffers to different labor representatives. However, it is not in the management interest to nullify labor power, since it can potentially give them support against outsiders. Having in mind just that outside threat, the managers will persist on having no more than one labor union in the firm. It is much easier to influence one labor leadership than several.

V. Endogenous corruption

Once settled, the labor union in a privatized company can further its interests. Members of the union prefer job security to higher wages and salaries. If they are at the same time inside shareholders, they will expect some dividends, but surely enough, retaining jobs is their primary concern. Union leadership must respect medium voter preferences, and therefore it will select one or mixture of the following strategies:

- Try to sway managers pointing to deteriorating living standard and uncertain position of labor the force in privatized company. However, begging is seldom a useful strategy.
- Threaten with strike, which would send a warning to shareholders, but also dissuade potential outside investors from investing in the firm. This strategy can be powerful, but also risky. By pursuing it, labor union can easily shoot into its own leg – the lack of new investments can lead to further contraction in production, and consequently to the loss of jobs.
- Make a coalition with outside owners in order to topple present management. However, outsiders are mainly interested in obtaining profit. Once in charge, they will restructure the firm and fire all those virtually employed. Therefore, this strategy is counterproductive in the long run.
- Offer a deal (bribe) to the manager, in order to accept inefficient scale of employment. Wasteful employment and bribes can be financed through further exploitation of the market power. This strategy proves to be dominant.

Since managers' position is also precarious, they have to take a counter-move. Their primary interest is to retain control over the firm. That is the only way to keep on milking somebody else's resources, which is practically the principal way for making private capital. Only secondly they are interested in gaining the reputation of a tough bargainer (efficient manager). Their most likely options are:

- Try a crackdown on labor union, or intimidate their leaders. The strategy might be efficient, but somewhat risky. It can bolster workers' resistance and ruin firm's public image. Outside owners will certainly react, at least by selling their shares, with consequent drop in share prices.
- Accept nominally all employees' demands for job security, and try to shift the final showdown as far as possible in the future. In the meantime the management has to sway union leadership, or organize a substantial opposition that would undermine their position.
- Fully defend previous employment policies. That could bring a temporary relief (easing tensions with labor), but in the log run the strategy would be the losing one. Certainly it will not raise firm's profits, and outside owners would either organize a coalition in order to replace managers, or they would sell their shares. Both reactions are unfavorable to the management – they either lose job, or reputation.

- Accept union's offer and cooperate with it on the employment issue. The outsiders have to be constantly persuaded that the firm is restructuring slowly in order to keep good industrial relations, and that profits are round the corner. This strategy easily dominates the others.

The third set of actors in this game are the outside owners. They are mainly interested in obtaining a capital gain (difference between buying and selling price), and only secondly they are interested in dividends, or acquiring control over production. Anyway, their set of options is very limited. They can either sell the shares if the things turn sour, and very likely lose the money since capital market is very limited and potential investors do not expect improvement in firm's profitability, or try to organize a coalition against the management, which is tedious and uncertain. With first signs of bad industrial relations within the firm they will probably try to replace the management. We have already seen that the task is not an easy one. They will have to organize a coalition, comprising small investors who own dispersed ownership claims. They may even try to include inside owners who dare to oppose the management. However, their objective is quite clear to everyone – they want to improve *x-efficiency* of the firm in order to raise its value. Therefore employees/owners are aware that by supporting outside owners they are nearer to the restructuring, which might have a considerable unfavorable trade-off (loss of job in order to obtain a small dividend). Obviously, it is not in their interest to support outsiders, so the latter must count on their own.

As we can see, both managers and employees realize that the only winning strategy is mutual cooperation. The only force that can protect managers from outside owners is a strong workers' union. So their immediate interest is to organize workers and control their might through corrupt officials. Therefore, they will bribe workers' leaders in order to develop and maintain a credible protection force. They may supply them with plush offices and firm's car with a driver, arrange free meals in expensive restaurants, and pay for their family vacations. All these expenses can be included in firm's costs, since there is no real competition in the industry. Therefore, costs are raised in comparison to the competitive level and they can remain so high. At the end of the year, books show no profit, and therefore no dividends are disbursed. Clearly, outside owners are the principal losers of this game, but buyers also pay higher prices and consequently lose a part of the consumers' surplus.

Employees find their interest in supporting these policies. They will maintain their positions in the firm, and receive wages and salaries, which, however low, are still higher than the lost dividend (if they have some ownership claims in the firm). They will vote for union leaders who deliver job security, although they are aware of special liaison between union leaders and the management.

Union leaders are obviously better off with these policies. They can lead relatively luxurious lives, having a strong backing in their power base, with only moral costs of turning a blind eye to management's misconduct. However, they are aware that their and management's perks are part of firm's profits, and also witness other malfeasant behavior by managers, i.e. their appropriation of firm's rents. The varying degree of corruption is needed for union leaders to participate in this game, but some would be willing to accept even a stagnant or deteriorating material position of their power base in order to improve their personal gain. Clearly, the principal sources of mutual bribes are rents associated with the market power of the firm.

We may call this process the ENDOGENOUS CORRUPTION. It is endogenous as a consequence of systemic changes in the ownership structure. It was neither imposed from some outside (for example cultural) factor, nor a consequence of deteriorating living standard. It is simply a built-in mechanism whose forces are unleashed with the termination of state and communist party control, and general failure to create an effective outside ownership. It is highly spread across many post-communist countries, whenever the new governance structure of privatized firms is not in hands of one dominant (strategic) investor. We find this practice as the principal cause of high corruption rates in the region. Not only that it transfers tremendous amounts of wealth, but it also spreads the notion that common (group) interest must prevail over the benefit of the general public.

Some forms of corruption, specifically in an over-regulated environment, can be beneficial. They can supply "grease for the squeaking wheels of a rigid administration". But endogenous corruption is clearly harmful. In that game corrupt managers and union leaders win, and employees retain their jobs, which they value the most. Even employees/shareholders are better off, since they prefer job security to small dividend claims. The only real losers are outsiders – owners who do not receive dividends and consumers who pay higher prices for products and services of corrupt industries. It can be shown that their combined loss is always greater than the gain of better off parties (see the Research Paper).

VI. Typology of endogenous corruption

The social loss due to endogenous corruption critically depends on the elasticity of demand. In the unlikely case of perfect competition i.e. infinite elasticity of demand, there is no opportunity for raising prices above competitive costs. Therefore, no rents exist, and both supply and demand for corrupt payments reduce to zero. As price elasticity falls, a split between price and marginal revenue emerges, and optimizing producers find their equilibrium by equating marginal costs with marginal revenues. Consequently, price is above cost, some actors receive rents, and an opportunity for endogenous corruption has been created. As marginal costs cannot be negative, marginal revenue must be also nonnegative, which practically means elasticity of demand equal to, or greater than one. In the former case (elasticity equal to one) - although an extreme case (zero marginal cost) – the most favorable condition for endogenous corruption has been defined.

The other critical element that must be taken into consideration is the ownership structure. It can be inside dominated, or outside dominated, and in both cases either dispersed or concentrated. The most favorable case for endogenous corruption is insider dominated dispersed ownership structure (employee ownership). The next favorable environment is insider concentrated (managers and employees), and finally follows outside dispersed (voucher scheme). Outside concentrated ownership creates very few opportunities for endogenous corruption. We can summarize these findings in a following table (Table 1).

Table 1. Typology o Endogenous Corruption					
			Elasticity of Demand		
			Low (higher than one)	High	Infinite
Ownership	Inside dominated	Concentrated	+	+-	0
		Dispersed	++	+	0
	Outside dominated	Concentrated	+-	-	0
		Dispersed	+	-	0

Note
Level of corruption: ++ very high; + high; +- low; - sporadic; 0 nonexistent

VI. Policy alternatives

Endogenous corruption cements the coalition of interests within firm against outside investors. The vested interests are financially supported by rents collected in an uncompetitive market, and a new climate favorable for corruption has been created. Managers corrupt union leaders, who turn their blind eye to diversion of capital's income into managers' pockets. Union members are happy to retain their jobs and their social benefits (health and pension insurances, transportation and lunch allowances), and consequently do not want to rock the boat. Not unexpectedly, privatized firms with dominant insider ownership usually pay no dividends to outside investors.

From the social point of view it is immaterial which way the payment goes, since endogenous corruption is a kind of redistribution of rents. The social interest must be focused on allocative efficiency losses that are substantial in the arrangement. Since the gains to insiders are highly concentrated, and the welfare loss is disseminated among many consumers and small investors, the deal reached within the privatized firm will remain unopposed. This fact is in concert with economic thinking, according to which large groups composed of rational individuals will not act in their group interests (Olson’s paradox).

Endogenous corruption cannot be eradicated easily. One might add that it can be unearthed even more painfully than regular forms of corruption. Customary anticorruption devices usually cannot tackle the endogenous corruption. For example, a common anticorruption strategy is development of an independent civil sector, typically in the form of non-governmental organizations. But partly out of misapprehension, partly out of prejudices, watchdogs of public interest in the post-communist society may find the announced deal between management and union leaders praiseworthy, since it preserves jobs against the selfish interests of "outside greedy shareholders".

Therefore, a comprehensive policy against endogenous corruption must be designed carefully. Since absence of such a policy is also an option, we will start with the analysis of its probable outcomes.

a) Doing nothing

One may conclude that the endogenous corruption is limited in scope, and also concentrated in big industrial plants that are inefficient in any way. With continual process of capital milking ("tunneling"), managers will at a certain point become either capable of organizing production in their private enterprises, or become rich enough to buy-out. In both cases they will show enough material interest in organizing economically efficient firms. This rationale may be used as an excuse not to devise any active policy against endogenous corruption. A cynical remark might be added that previous reasoning is especially exacerbated in the situation when managers of privatized firms support politicians that are currently in power (though smart managers finance both the government and the opposition politicians).

Although there may not be adopted any explicit policy toward endogenous corruption, some other policies exert a substantial influence on its level. Therefore, they must be included as variants of this policy option. The most highly profiled and most popular in the region are the following:

- *Industry protection.* Privatized firms are clearly inefficient. They cannot bear foreign competition. Therefore, in order to reduce the trade deficit, the government imposes export subsidies, import duties, and/or additional barrier to entry. The policy raises firm's rents, which can virtually satisfy all vested interests – managers accrue more income, labor retain jobs and receive higher remuneration, even outside owners receive some dividends. The only losers are consumers who pay more dearly for goods and services, and most likely pay higher taxes. The policy usually runs unopposed due to Olson's paradox.
- *Suspension of managers' rights.* If the public opinion strongly opposes enrichment of the managerial class (it rarely opposes industry protection, since it is good for "national interests" – whatever it may mean), the government may introduce new rules of conduct. For example, an ex-manager of privatized company cannot open his own business for a certain period; even his relatives cannot open business in the same industry etc. Some countries also introduce retroactive taxation and/or additional property taxes. In all these variants managers have less incentives to participate in corrupt activities, although it is not for granted that the outsiders will be better off.
- *Boosting inflation.* All transition economies have great problems with government finances. Substantial deficits are inflationary financed. Although government's primary goal is to cover the gap between expenditure and revenue, not to give an additional impetus to managerial diversion of resources, in practice this policy promotes corruption. Inflation allows monopolies to raise prices above the average inflation rate, although cost borne by monopolies may not follow the same pattern. Also, capital depreciation is not calculated in real terms, which creates windfall profits for monopolies only due to inadequate accounting standards. As we have witnessed, larger rents (profits) allow higher corruption rate in general, and endogenous corruption in particular.

Adverse consequences of inactive policy toward endogenous corruption may be mainly located in the realm of macroeconomic efficiency losses. Privatized firms falter, since their already low physical productivity is coupled with rising costs. This translates directly into deteriorating terms of trade, loss of foreign markets, and increase in the trade deficit. Export can be maintained only trough heavy subsidies, which place a new burden on the already exhausted economy. Surplus labor in privatized companies and delayed restructuring are not attractive for potential foreign investors, therefore there is a lack of foreign direct investment. "Greenfield investment" is also slack due to barriers to entry. Dying down of privatized companies and creation of several small units may mean loss of economies of scale and scope, with further degradation of comparative advantages in the international trade.

b) New legislation

The usual way to make an impact on the processes in post-communist societies is through the legislative activities. A plethora of new laws has been created each day. It costs very little to pass a new law and there is already overstaffed administration eager to implement new regulations. However, the benefits are also low, since a tremendous pile of (often conflicting) legislation, incite citizens not to obey to the law. That creates further degradation of the rule of law.

Anyhow, if there is substantial pressure from the public opinion do take some steps against corruption, a new law can be crafted, with special provisions against endogenous corruption. That will bring very few effects, since in most cases corruption goes unreported and both sides have incentives not to reveal the deal.

Instead of fighting consequences, it is more effective to search for causes of endogenous corruption, and counter them with new legislation. The new laws and rulings are necessary in the following areas:

- **Privatization law.** If the privatization process has not been completed yet, new provisions must be brought in order to stimulate outside concentrated ownership, preferable by strategic investors. If the same law regulates investment funds, new provisions must be made in order to concentrate ownership claims (maximal percentage of shares held by an investment fund has to be lifted).
- **Commercial law.** Governance of the joint stock companies must be carefully crafted, with special provisions for protection of minority rights, rules of representation at the shareholders' meetings, prohibition of inside dealings, conflict of interest prevention, debt-equity easement and stimulation.
- **Labor law.** Provisions concerning unionization and labor representation must be thoroughly examined. Setup of new labor unions must be eased, their competition stimulated, with precise rules of representation during negotiations with the management. Labor participation in firm's governing bodies must be abandoned since in practice it represents an invitation for corruption.
- **Anti-trust law.** All barriers to entry must be removed and free access to all industries granted. Natural monopolies have to be regulated in a transparent way, by establishing state and local regulatory commissions (their rule of conduct must be prescribed in advance).

- **Freedom of information act.** Since mafia-type activities are highly disseminated in the region, the law must protect supply and demand of information. Exposure of secret deals must be stimulated, journalists protected, as well as their sources of information.

These substantial changes in the rule of the game may be accompanied with some pro-active policies that can be taken as variants of the same legislative approach. The most effective are the following:

- *Clean hands policy.* The government must delegate into state firm's governing body persons with impeccable past. That will be a positive incentive to all soundly led companies to hire similar persons in their respective corporate governance boards. It can be also stipulated that certain number of the supervisory board members come from professionals, academics, or some other highly appreciated positions.
- *Anti-corruption council.* The government may establish a council of experts (lawyers, economists, honorable politicians, journalists, academicians, representatives of non-governmental organizations dealing with corruption) as an advisory body to the Cabinet. The council will organize public inquires, debates, hearings, issue statements, and advise new legislation and measures against corruption.
- *Media and civil society support.* The government may have as a persistent policy support for the independent media and parts of the civil society interested in combating corruption. Support may range from material help to giving special tips, or easier access to the information.

If this policy option is implemented consistently, together with some (or all) of its variants, it can deliver substantial improvement in few years time. However, one must have in mind that even some countries that have a long tradition of the rule of law have not solved even the classical corruption problem. The illustrative example is Italy, which could not have solved major corruption scandals even after twenty years of public inquiry. The situation there is much better than it used to be, but still the country is far from the Nordic standards of low corruption. In the ex-communist countries the rule of law concept is still at an early stage, and new forms of corruption emerge along with the classical. Therefore, expected outcomes of this policy option must be even more modest than in developed countries.

c) Public relation initiative

If the government has limited expectations from the legislative attack on corruption, it can opt for some kind of public campaign against corruption. The government may pursue with public relation initiative, stressing that now, after the democratic change, everything depends on individual grapple with the problem. Since the laws are cumbersome and nobody abides to the law, the struggle against corruption critically depends on individual and local ingenuity.

This policy option may have the next elements:

- **Media campaign against corruption.** The public opinion in the communist period had been indoctrinated in favor of egalitarianism. That view was supported by the false Marxian labor theory of value, according to which remuneration has to be subject to labor exerted in the production process. Therefore, if somebody's income is not commensurable to the labor exerted, it must be unearned (result of exploitation). Although the whole construct is false, long lasting indoctrination created a widespread acceptance. The government can exploit that sentiment and organize a strong campaign against corruption. The main accent may be on inequality created by corrupt practices. There is even some room for struggle against endogenous corruption, since employees already having their jobs are considered in the present situation of high unemployment as privileged. If their wages and salaries are at the same time exposed (much higher than in the rest of the economy, owing to the distribution of rents), the public sentiment will certainly turn against corrupt deals.

- **Media campaign against monopolistic practices.** Campaign may be led not only against corrupt deals, but also more broadly against all monopolistic practices. Therefore, this can be considered as a variant of the previous approach. However, a general struggle against monopolies will not be as accepted as the struggle against inequality, since the public accepts the biggest monopolistic firms as "family silver" – for the long time greatest employers in their respective regions, but also largest exporters and suppliers of some public goods. Also, it will be hard to elucidate the necessity to have competition on the labor market, to have several labor unions, and to explain harmful effects of labor participation in the firm's management.
- **Public exposure of corrupt deals and officials implicated.** It will be relatively easy to get a public approval for the exposure of some corrupt government official. The overwhelming evidence of high living standards can be a substitute for definite proof of wrongdoing. The same is true for employees who receive wages and salaries substantially higher than the medium income. It will be, however, much trickier to explain that some employees retain their jobs only owing to endogenous corruption, although their monthly remuneration hardly covers existence level, i.e. that they should lose their jobs and positions despite their subsistence wages. If there are very few opportunities for alternative employment, the task seems almost impracticable.

Public campaign may demand a lot of time and resources, which are anyway scarce. The success is not warranted, and sometimes the result may be unexpected. Sometimes it can be a two-blades sword: public sentiment may turn against each entrepreneurial activity, or may strongly favor egalitarian income policy, which could jeopardize prospects for economic development.

d) Liberalization policy

Since the combined gain to insiders is always less than the loss to outsiders, endogenous corruption diminishes social welfare. Moreover, it has devastating allocation effects. Through commodity interconnectedness it reduces profits in other industries and creates substantial efficiency losses. Its perseverance, however, crucially depends on the extent of market competition. With rising elasticity of demand for firm's products, there will be constantly less means for corruptive behavior. Conventional wisdom states that it is always useful to have strong competition on product and factor markets, but such recommendation is especially justified in situations where endogenous corruption is rife. Therefore, one additional argument in favor of an active competition policy has been created, and that is another policy option - strong orientation toward economic liberalization.

The liberalization policy must have two different tracks:

- Foreign liberalization, i.e. opening up of domestic markets to foreign competition by:
  - Simplifying foreign trade dealings (abandonment of import quotas, licenses, easier access to domestic market, etc.);
  - Lowering custom duties and taxes;
  - Credible exchange-rate policy,
  - Simplifying procedures for foreign direct investment,
  - No limits on profit repatriation.

- Internal liberalization
  - Simplifying procedures for starting new businesses, which have to be rule-based, streamlined and transparent;
  - Developing effective bankruptcy procedures;
  - Reform of the tax collection system;
  - Lowering the levies;
  - Creation of legal and enforcement mechanisms for penalizing anti-competitive behavior, etc.

The main objective of this policy option is to create an open economy completely integrated into the global trade. Therefore, economic system must be completely commensurable to the rest of the world economy. In order to achieve that goal, additional systemic changes must be introduced:

- **General accounting principles** (**GAP**). Socialist governments had introduced accounting rules with the primary goal to control material flows. Only sporadically some countries have moved toward a market system of financial control. However, in the last ten years some advanced reformers made a substantial move accepting European Accounting Standards. Since the EU is the main economic partner, this policy proved right, but having in mind globalization trends, it is advisable to make a system fully matching the American standard practices (GAP).
- **Financial markets.** All obstacles to a free trade in shares, debentures, options, futures, and all other financial instruments, must be lifted. However, financial markets are still in the emerging stage. For the long period they will remain very shallow, and their ability to collect greater amounts of money will remain limited. Therefore, there is no need for each country to develop its own stock exchange, which means that it can use facilities in the neighboring countries. If, for example, the Budapest Stock Exchange is more advanced, there is no need to develop a domestic stock exchange. Of course, the most attractive firms should try to enter even bigger trade centers. If, however, the government decides to support domestic Stock Exchange, the

adopted rules must be harmonized with rules prevalent at the global market.

- **Currency**. Some regional countries will be accepted as new members of the European Union in the first wave. Others are in accession or association processes, with an equal prospect to be included in the European Monetary Union (Euro Zone). Therefore, it is a necessity for all countries in the region to facilitate trade in euros. If a country does not meet standards for the inclusion in the European Monetary System, it may consider eurization – acceptance of euro for domestic currency. Smaller economies can easily adopt European currency, since population already uses it for bigger transactions and for saving purposes. Larger economies could experience troubles with abandoning domestic currency, so if costs outweigh benefits, change to euro could be postponed. In the meantime, stable monetary policy is essential, which can be achieved by using the currency board.
- **Competition policy.** This is an essential part of the liberalization endeavor and, as such, it has been already emphasized. Here we may only add that it has to be completely in accordance with North American and European standards.

All these measures cannot be introduced overnight. However, simplified procedures for starting new businesses and relieve of the tax burden can be quickly accomplished, and the main positive effects can be expected in a half year period. This is, of course, subject to the political stability and confidence of investors in government reliability. Foreign liberalization will create trade deficits that may be substantial in the first two years of the policy implementation, but export will grow with the restructuring of domestic economy, and in the medium range period the balance of foreign trade will be accomplished. However, restructuring of domestic firms will initially increase the unemployment rate, which can create substantial political problems. It is, therefore, an absolute priority to start with simplifying procedures for business start up, in order to absorb surplus labor. From the point of view of endogenous corruption, this policy option is absolutely dominant comparing with the other alternatives. It can be expected that the endogenous corruption will die down in few years period.

VII. Proposed strategy

It is to be expected that liberalization policy will be opposed by a concert of vested interests and misapprehension by the general public. There will be two hostile tendencies: one based purely on ideological grounds, and the other founded on vested interests. Some people are against foreign goods in principle, since they "ruin" domestic production, and the others are against all measures that might be harmful toward laboring classes. The first orientation is particularly present in ex-communist countries that promote nationalistic feelings, and the other is widespread in countries where the official communist propaganda had promulgated some version of worker self-governance myth (successor countries of ex-Yugoslavia, Poland, USSR). Of course, vested interests will create more problems. Labor unions have a substantial leverage in some countries in the region, and the managerial class influence is far from remising.

a) Vested interests must be identified and exposed

Vested interests can create serious problems in countries that have not replaced management structure after the collapse of the communist regime. Managers used to be members of the nomenklatura, which had a long tradition of good relationships with top politicians, not infrequently with opposition leaders. Once the opposition took over, they retained the privileged position. In some countries they are so powerful that the government always reconsider what the managers' reaction to a certain measure will be.

Potentially a more serious threat comes from the formerly independent unions. Their leaders come from the same circle as most prominent political leaders of the post-communism, and they have mutually developed an "old buddies" relationship over time. Therefore, politicians are reluctant to take up steps to limit union's role in privatized firms. That fact is readily accepted by union leaders, who often try to establish themselves as inescapable power brokers. Their distinguished position vis-à-vis firm's management is a prelude to the endogenous corruption.

b) Public relations initiative is necessary

It is therefore necessary to explain to the general public that insider deals may benefit some, but social costs can be truly high. Of course, such a campaign can have only a limited impact, but it is useful to remind people that well-being of a certain company and persons employed there need not be good for consumers. The remainder might sound quite strange to some who were protractedly exposed to the communist indoctrination, which glorified production as the focus of interest. A new orientation is needed in many post-communist countries, from production centered, seller's market, to consumer friendly, buyer's market. This task seems of gigantic proportions, but one must have in mind that after each major political turn, such as revolution, foreign invasion, or fall of a dictatorial regime, the general public is willing to accept a change in their behavior attitudes.

c) Mutually consistent and reinforcing reforms must be devised

The most challenging effort must be exerted on development of a new economic system. First of all, an *effective privatization strategy* has to be devised in order to produce concentrated outside ownership for privatized firms. All privatization models that give an upper hand to insiders may be politically opportunistic and thus favorable in the short run, but in the long run they result in substantial endogenous corruption that may raise the overall level of corruption in the country.

Nations that have already privatized greater part of state controlled assets, should concentrate their efforts on *developing commercial law* that would limit inside-dealing, conflict of interest, and protect minority shareholders. But they will also have to raise *accounting standards*, increase transparency of *corporate decision-making* process, and foster competition on the *labor market*.

d) The final success critically depends on the resources and expertise devoted to development of a credible and competitive market system

In the long run the only viable policy against endogenous corruption seems to be development of the new business elite. Instead of borrowing abroad and investing in companies infested with endogenous corruption, the government should invest in human capital. It should send bright students to the West, urging them to study particularly commercial law, accounting and auditing proficiencies, business administration, industrial policy and regulatory practices. Some of them will stay in the West, but many will return, and with rising standard of living in native countries, many more will. Returns in real economic terms to investment in human capital are the highest, but more than that, a prolonged exposure to business practices in counties notorious of honest dealings will have a healing effect on endogenous corruption.

VIII. Implementation issues

a) Political acceptability

As we have already seen, battle against corruption is likely to be accepted by the broad strata of population. There is a general impression that the previous communist regime was corrupt, since its proponents advocated equality and modesty but lived completely different lifestyles instead. After the collapse of the Berlin Wall new elites were put in charge all over the Central and Eastern Europe. The populace still has high expectations of new regimes, and gives legitimacy to its leaders only if they succumb to the social contract in which there is no place for corruption. The new governing elite must exploit this positive orientation and build a comprehensive anti-corruption strategy. New forms of corruption must be included into this program, since different types of corruption tend to support each other. The endogenous corruption must have a privileged position in that effort, since it comprise a large section of the populace. On the other side of the same token, broad dissemination of endogenous corruption means that resistance to the envisaged policy will be substantial. Therefore, public relation initiative is essential. All aspects of endogenous corruption must be put in plain words, its devastating consequences on the resource allocation examined, and advantages of the new liberal regime explained. The fact that the international community places anti corruption policy high on its agenda gives a special impetus to policy advocates, as the greatest part of voting population would like to see the country integrated into European structures.

b) Proposed actions and accountability.

In order to coordinate proposed policies a new Task Force has to be formed out of ministries involved in the process. The Task Force will ensure a continual flow of information between institutions involved. The principal members of the Force will be ministers of economy and privatization, finance, foreign trade, and information. It is also important to include representatives of the Anti-Monopoly Commission, Stock and Exchange Commission, Anti-

Corruption Council. The main envisioned activities; accountability of different actors, and timing of the process is summarized in the following table (Table 2).

Table 2. Accountability and Timing

Institution	Main regulation	Preparation	Implementation	**Follow up**
Ministry of Economy	Start up of new firms	1 month	6 months	6 months
Ministry of Privatization	Amendments to the Privatization Act	6 months	1 year	4 years
Ministry of Finance	Self-Dealing, Investment funds	3 months	1 year	Continual
Ministry of Foreign Trade	Set of liberalization laws	1 year	2 years	6 months
Ministry of Information	Freedom of Information Act	3 months	6 months	Continual
Anti-Monopoly Commission	Competition Laws & Natural Monopoly Regulation	2 years	1 year	Continual
Securities and Exchange Commission	Issue & trade in securities	6 months	1 year	Continual

c) Financial impact

The existing allocation of budgetary resources has to be obeyed in principle. Ministries of Privatization, Economy, and Finance, are already equipped in most countries under consideration with adequate resources and personnel. Therefore they can accomplish additional tasks without additional funding. Foreign Trade Ministry and Anti-Monopoly Commission face a challenging burden, since they have to harmonize a bulk of legislation with the existing regulation in the European Union, United States, and the World Trade Organization. These institutions need additional personnel and funding, which has to be taken into account.

d) Evaluation of the policy

It is useful that the Cabinet make at least monthly evaluation of pursued policies. Criteria for evaluation have to be prepared in advance, preferably by the Task Force, and accepted at one of the first meetings of the Cabinet. The criteria should include at least the following:

- Survey of the four-firm concentration ratio for different industries (share of biggest 4 companies in industry supply);
- Overall Herfindahl-Hirschman Index (HHI), and survey of industries having value of HHI greater than 1000;
- Number and distribution of privatized companies with insider majority shareholding;
- Survey of privatized companies not paying dividends.

If the Cabinet rules that after 1 year of policy accomplishment there has been no real progress in combat against endogenous corruption, the policy should be reexamined and new measures considered for implementation.